Discussion of "Dynamic Prudential Regulation" by Ajay Subramanian and Baozhong Yang

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The views expressed in this talk do not necessarily reflect the views of the World Bank, its Executive Board or the countries it represents.

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2. Studies optimal financial regulation in the presence of social liquidation costs
   - At **high levels of distress**, there is a social preference for risk
   - Intervention within a "band"
3. Calibrate the optimal policy to US data

What I'm going to do

- Discuss the relevant *context*
- Make some suggestions about the calibration

Why is this paper about banks?

- The setup could be applied to any firm:
  - Corporate rather than financial regulation?
- Banks are different because of systemic risk... But, is this model useful for thinking about that?

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  - Banks take on too much risk when in distress.
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- **Crisis:**
  - Before the crisis: too much risk, no distress
  - During the crisis: too *little* risk, distress

Suggested framing

- General model of dynamic asset substitution
  - Highlight the added insights from the *dynamic* aspect (just moral hazard, or something more?)
- *Calibrated* to the (non-systemic) financial sector

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  - Or, match the probability of becoming distressed
- Anticipated bailouts?
  - A case can be made wrt *systemic* risk
  - But if the focus is on non-systemic risk, to what extent is this relevant?

Conclusion

- Beautifully written paper, many relevant issues
- Main comment: differentiate better between systemic and non systemic
  - Asset substitution doesn't seem to be relevant for systemic events
  - Bailouts do not seem to be relevant for non-systemic events